In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1184

FIRST NATIONAL INDUSTRIES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit is reported at 404 F. 2d 1182. The opinion of the Tax Court, T.C. Memo. 1967–136 (Pet. A8–A16), is not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on December 26, 1968 (Pet. A1). The petition for writ of certiorari was filed on March 21, 1969. The jurisdiction of this court is invoked under 28 U.S.C. 1254 (1).

347-565—69

QUESTION PRESENTED

Whether the transaction whereby petitioner transferred pledged stock to its parent, a tax-exempt foundation, resulted in the realization of a capital gain to petitioner under Section 1001 of the Internal Revenue Code of 1954 to the extent the value of the stock exceeded petitioner's basis at the time of transfer?

STATUTE INVOLVED

The relevant portions of the Internal Revenue Code of 1954 are as follows:

Section 1001(b):

* * * * *

(b) AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *.

* * * * *

Section 311:

(a) GENERAL RULE.—Except as provided in subsections (b) and (c) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

(1) its stock (or rights to acquire its stock), or

(2) property.

* * * * *

(c) LIABILITY IN EXCESS OF BASIS.—If—

(1) a corporation distributes property to a shareholder with respect to its stock,

(2) such property is subject to a liability, or the shareholder assumes a liability of the corpo-

ration in connection with the distribution, and

(3) the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property,

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

STATEMENT

Petitioner is one of six corporations owned or controlled by the Church of Christ Foundation, Inc., a non-profit Foundation. (Pet. A1.) After pledging a thousand shares of stock of an entirely distinct company with a bank as collateral for a $750,000 loan, petitioner transferred the stock to its parent Foundation. The bank released the stock for the transfer, but the Foundation immediately repledged the stock for petitioner's loan. (Pet. A2–A3.) The Foundation later caused the issuing company to redeem the stock, and pledged that company's note, which was received in the redemption, to secure petitioner's bank indebtedness. The Foundation subsequently sold the note to the lending bank for $700,000, and advanced the sum to another company whose stock was fully owned by the Foundation. The latter company then made payments to three of the Foundation's other subsidiaries to pay off certain indebtedness, which in turn paid the

$700,000 to petitioner on account of their obligations to it. Petitioner then paid off its note to the bank with the $700,000. (Pet. A2.)

The Commissioner determined a deficiency in petitioner's income for fiscal year ending January 31, 1959, taking the position that petitioner realized a long-term capital gain of $600,000, the difference between $700,000 and petitioner's basis (Pet. A2.) The Tax Court rejected petitioner's argument that it only made a gift to the Foundation of its equity in the stock[1] and held that since petitioner essentially remained obligated to the bank (Pet. A2), in substance petitioner received the same benefit as if it had utilized the stock to discharge its $700,000 loan indebtedness (Pet. A8–A16).

In the alternative, the Tax Court concluded that the transfer was a dividend in kind to taxpayer's parent, with the distributed property subject to a liability in excess of its basis to petitioner when distributed (Pet. A15), which is a taxable event under Section 311(c) of the 1954 Code. The court of appeals affirmed, viewing the transaction in issue as basically equivalent to a sale of stock by petitioner, finding it unnecessary to consider the Tax Court's alternative position (Pet. A8).

ARGUMENT

1. Although a gift of property that has increased in value does not normally result in income to the donor, *Humacid Co.* v. *Commissioner,* 42 T.C. 894,

[1] The corollary of this theory was that any sale was made by the tax exempt Foundation.

where the donated property is subject to a mortgage the circumstances surrounding the transfer may be such that it is in substance a sale rather than a "gift", and taxable gain results. *Simon* v. *Commissioner*, 32 T.C. 935, affirmed, 285 F. 2d 422 (C.A. 3). This occurs whenever the transfer results in the discharge of the transferor's indebtedness in an amount that exceeds his basis in the property,[2] a rule that encompasses the particular factual pattern of the transactions here. In spite of the seeming complexities of what was done, petitioner in substance transferred its equity in the stock, and the funds generated upon its disposition by the purported transferee were used to pay petitioner's bank obligation. Petitioner was able to secure bank credit of $700,000 at a cost of $100,000, by virtue of the Foundation's almost instantaneous repledge of the stock, and then was relieved of that debt through its parent's use of the stock. "[B]y this roundabout process petitioner received the same benefit" as though the Foundation had directly paid its note upon acquiring the stock. See *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613. Thus the decision below does not, as petitioner contends, make any gift

[2] *International F. Corp.* v. *Commissioner*, 135 F. 2d 310 (C.A. 2); *United States* v. *General Shoe Corp.*, 282 F. 2d 9 (C.A. 6); *A. P. Smith Manufacturing Co.* v. *United States*, 364 F. 2d 831 (Ct. Cl.) certiorari denied, 385 U.S. 1003; *Tasty Baking Co.* v. *United States*, 393 F. 2d 992 (Ct. Cl.); *Riley* v. *Commissioner*, 328 F. 2d 428 (C.A. 5).

of encumbered property a taxable event to the donor (Pet. 5–6).[3]

2. Petitioner premises its certiorari petition (p. 5) on the absence of a formal assumption of the bank loan on the part of the Foundation, relying on *Crane* v. *Commissioner*, 331 U.S. 1. Of course, it is clear from *Crane* that a formal assumption would require the decision reached below. But it does not follow that the lack of that nicety calls for reversal. In seeking to limit the scope of *Crane* to cases where the transferee formally assumes the debt, petitioner disregards the realities of the present situation. This Court has made it clear in *Crane* that assumption is not a prerequisite to the realization of income. Whether the property is transferred subject to the debt, or the debt is assumed by the transferee, the transferor is freed of his own obligation when the transferee discharges or provides the means for discharging the debt. Here there was just such a transfer of encumbered property that, even without assumption, effected the discharge of the transferor.

[3] We seriously question whether the appellate court was correct in apparently accepting petitioner's characterization of its transfer as a "gift". This brief discusses petitioner's position on the assumption that a "gift" occurred, but we would suggest that the Tax Court's alternative ground is the preferable basis for decision here, *i.e.*, that the transfer to the Foundation was a dividend distribution in kind which, under Section 311(c) of the 1954 Code, would result in the realization of taxable gain by the petitioner. *Crosby Valve & Gage Co.* v. *Commissioner*, 380 F. 2d 146 (C.A. 1), certiorari denied, 389 U.S. 976; *United States* v. *Knapp Brothers Shoe Manufacturing Corp.*, 384 F. 2d 692 (C.A. 1), certiorari denied, 390 U.S. 989.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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